

Before the
INTERSTATE COMMERCE COMMISSION

Revenues of Rail Carriers in Official
Classification Territory
on Petition for Modification of Order

Statement of
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The European War is a new factor of tremendous importance in the railroad situation.

Before the outbreak of hostilities, the position of the railroads was bad enough, facing as they did the necessity of giving permanent form to a large volume of temporary financing, and of providing the money for extensive improvements, with insufficient earnings to tempt the conservative investor into buying bonds, and insufficient prospects to tempt the speculative investor into buying stocks. Railroad earnings are now probably the most important single influence affecting the banking situation of this country, and through the banking situation, the general financial and commercial situation; they no longer, as until recently, principally affect the railroads, their creditors and shareholders, and only incidentally other industrial labor.

For some years past there has been a growing disproportion between the enormous credit structure of the railroads, as evidenced by their fixed interest-bearing obligations, and the comparatively inadequate foundation of stock, on which this credit structure rests. In raising capital, the railroads have had to sell fixed interest-bearing obligations where they could not sell stock. Debt has been piled high and the equity back of that debt, the owners' contribution to the business, has not been increased in proportion. The cause of this is obvious. The price of very few railroad stocks was sufficiently high to permit the raising of capital by the sale of stock at or above par. The Railroad Securities Commission, of which Mr. Hadley was Chairman, and of which your colleague, Commissioner Meyer, and myself were members, came to the conclusion and stated in its report that, while it was, generally speaking, a fundamental principle of sound finance that stocks should not be sold at less than their par, this restriction far from having led to the sale of *stock* at *par*, had as a matter of fact in many cases, resulted in the sale of *bonds* at a *discount*. The Commission therefore recommended that the sale of stock at a discount be not only permitted, but even, under certain conditions set forth in the report but not germane to the present case, encouraged, and then went on to say:

"If a road whose stock, for any reason whatsoever, sells below par is prohibited from issuing stock at less than par, it means that it must raise all its money by bonds. It is compelled to go more and more deeply into debt. The worse the financial position of the road, the stronger is the compulsion and the heavier are the interest charges on the bond. To compel the weaker roads to pursue their present policy of issuing fixed interest-bearing obligations by reason of their inability to sell stock at par may before long, by reason of a large crop of receiverships, result in intensifying the acuteness of the next panic and in prolonging the subsequent business depression."

That prediction has unfortunately come true.

Failure of a road to pay its regular dividend naturally has a bad effect upon the price of its stock, and when failure to pay dividends becomes general among railroads, the entire investment market is demoralized, but default in the payment of interest on *bonds*, has much worse consequences and affects the entire financial situation. Upon this point the Railroad Securities Commission said:

"The effect of a loss of dividends would have been felt chiefly by the individual stockholders; a default, or even a threatened default, of interest has an effect on the credit and confidence of the country as a whole, and may precipitate a financial crisis."

In still another part of its Report the Commission said:

"To the extent that we lessen debt, we shall increase the power of the roads to raise money when the public needs added facilities and shall at the same time reduce the chance of default and lessen the severity of commercial crises."

And later in speaking of reserve funds, the Commission makes use of language which I quote because it is equally applicable to the point that I am now discussing:

*"Railroad credit is an important asset to the entire country, and it should not be wasted. * * * We are only suggesting that the present generation shall not be unmindful of its obligations to future users of transportation."*

Now, the reason why the stocks of so few railroads have in recent times sold high enough to permit the roads to obtain any considerable portion of their capital from the sale thereof, is to be found in their diminishing net earnings, resulting in a diminishing surplus applicable to the payment of dividends. The few railroads that have been able to sell any considerable amount of stock, have found not only that their *actual* surplus has been

lessened, but worse, that the *percentage* of surplus on the outstanding capital stock has been lessened in even greater proportion by reason of the increased volume of stock.

I shall not, however, take up your time by enlarging further on the importance of checking this growing disparity between the amounts of bonds and the amount of stocks of the railroads; between the size of their credit structure and the size of the base on which the credit structure stands; between their fixed charges and their contingent charges; except to say that the principles that I have just stated, are at all times sound, no less today than before the war began. It has only been a question of time as to when this growing disparity, if not checked, would bring the railroads face to face with a crisis in their financial affairs, and even without the war, any financial disturbance of *ordinary* severity would within the next few years, have demonstrated the truth of this prediction. The present *unparalleled* crisis due to the European War has brought the railroads to the brink somewhat earlier than would otherwise have been the case. The railroads today are in a precarious condition. I do not mean to imply by what I have just said that the five per cent. increase in rates, even if granted without abatement, will at the present time enable the roads to correct these evils and to sell stock freely at par. The present application, if granted without abatement, cannot do more than hold the situation as it is, if indeed it can do that. The roads must for the present, continue as in the past, to put forth fixed interest-bearing obligations and they must try, at some later day, under happier financial skies, and under the fostering care of the Interstate Commerce Commission, to make good the relative disparity between the amount of bonds and stocks outstanding, by demonstrating to their stockholders their ability to earn and pay increased dividends. Thus only, can their stocks be made to sell at any considerable premium above par. The scramble for capital the world over is bound to continue for years to come, and dividends will have to be increased in order to attract capital to the stocks of railroads. If this is not done, their already overburdened credit will be further strained.

“Where the investment is secure, a reasonable return is a rate which approximates the rate of interest which prevails in other lines of industry. Where the future is uncertain the investor demands, and is justified in demanding, a chance of added profit to compensate for his risk. We cannot secure the immense amount of capital needed unless we make profits and risks commensurate.”

(Report of Railroad Securities Commission.)

"We have not developed our ideas of railroad management as far as we have developed our ideas of bank management. The subject is a more complex one. The apparent conflict of interests between the management and the customers is greater with a railroad than with a bank. As a result of this misunderstanding, the necessary development of railroad facilities is now endangered by the reluctance of investors to purchase new issues of railroad securities in the amounts required. This reluctance is likely to continue until the American public understands the essential community of interest between shipper and investor and the folly of attempting to protect the one by taking away the rewards of good management from the other."

(Report of Railroad Securities Commission.)

It should be borne in mind that the financing now required by the railroads will call for a high rate of interest, and that this burden will be felt for a long time to come. To encourage financing by short-time notes is to encourage bad financing. It is better that the railroads should for the next 20 or 30 or 40 years pay a high rate of interest on the capital now to be raised than that they should further endanger the entire financial situation by the continued issue of short-time obligations. Now, we must realize that higher rates of interest mean increased *cost* of transportation and unless accompanied by higher *rates* for transportation, mean a smaller surplus over fixed charges, and the smaller the surplus, the less the value of the equity, and the less the value of the equity, the lower the price of the equity, and the lower the price of the equity, the more disastrous the consequences to the financial and industrial enterprises of the country; and the more disastrous the consequences to these, the more unfortunate will be the condition of all the people in the United States, and most unfortunate of all, that of the laboring man.

Past expenditures by the railroads on capital account, have not brought adequate return, and in some cases no return at all. The increase in freight rates now asked for, while not adequate entirely and for all time, to solve the problem of how to secure ample capital, will, nevertheless, if granted, tend to re-establish confidence in the minds of investors. Under conditions as they were, and worse yet as they now are, how can conscientious bankers, mindful of the trust reposed in them by investors, freely recommend railroad stocks, or for that matter,

even some railroad bonds, as a safe investment? Other industries offer larger returns, with no greater risk, in fact, frequently with less risk, and bankers have, in many cases, felt compelled to advise those who rely upon them for advice, to keep out of railroad investments and to invest in industries that offer a better chance of profit with smaller chance of loss. Said the Railroad Securities Commission on this point:

“In no event can we expect railroads to be developed merely to pay their owners such a return as they could have obtained by the purchase of investment securities which do not involve the hazards of construction or the risks of operation.”

All of the foregoing, true at all times, is particularly to the point, at the present time. Unless the increase in rates is granted, as requested, earnings are likely to fall off heavily; they will probably fall off somewhat even if such increase be granted. The cost of labor will probably not rise for some time to come; the cost of supplies may be somewhat reduced; taxes are not likely to decline and the cost of interest will hereafter be heavy. The value of the equity back of bonds is likely therefore to be still further impaired.

The railroads will, we are told, need during the next fifteen months, some \$500,000,000 or more for refunding purposes merely. This is apart from expenditures for capital purposes other than refunding. Very little, if any, of this money can now be raised from the sale of stock. Nearly all of it will have to be raised by the sale of bonds, and, unfortunately, of bonds bearing a high rate of interest. The City of New York has had to pay 6% for money, besides a substantial commission through foreign exchange operations; railroads cannot therefore, expect to obtain their money cheaply. In fact, they may not be able to raise money at all, unless investors can be made to see that the securities offered are not only safe, but also likely to enhance in value. Reduction in dividends for the purpose of providing in part for the capital needs of the roads, besides being unfair to the investor, would only make matters worse, as this would cause a further depreciation in the price of railroad securities, both stocks and bonds, and, in addition, this step would be inadequate; the *entire* suspension of all dividends by *all* the railroads of the country would not provide even a tithe of the capital needed; it would produce more apprehension and panic, but hardly the needed money.

Now, the particular bearing of the foregoing on the present

general financial situation is this: At the moment, the stock exchanges of the country are closed. At what prices stocks and bonds will sell when these exchanges reopen, is problematic. Unquestionably, a large amount of liquidation will have to take place when the exchanges open, as many holders will have to sell because they need cash. This liquidation is practically certain to cause lower prices, how much lower, no one can say, for this will depend upon the volume of securities to be liquidated. If the volume of railroad securities then to be marketed by holders pressed for money is to be still further increased through offerings by those who, although not *obliged* to sell because of necessity, are *determined* to sell because of loss of confidence in the value of railroad securities as investments, the effect on the country cannot be other than disastrous. The first effect of such offerings would be to send prices to so low a level, as to make borrowers unable to make their loans good by furnishing additional security to meet the enormous shrinkage in values. This would be true of all borrowers, not only of those having speculative accounts. Brokers unable to obtain additional margin from customers would be compelled to offer their customers securities for sale in tremendous volume. So heavy would these offerings be, that prices would probably decline to a level where many brokers would no longer be able to meet their own obligations to the banks or to keep good the security for their loans; hence the banks themselves would be forced, to a large extent, to take over the securities on which they had made loans. Weaker banks would go under, and perhaps stronger ones also. Where it would all end, no one can tell. The effect of the banking position, in turn, on the industrial situation, would be lamentable. The banks would be unable to extend accommodation to industrial concerns, and many of these would likewise fail. Financial and industrial chaos would be the result. The effect on labor would be pitiful.

Aside from these acute effects, prices of all securities will necessarily be lower than formerly, because of the competition for new capital. The enormous destruction of capital by war, will compel European Governments to set the pace by their borrowings, on the basis of a higher return for its use, and this will be reflected in the prices of even the best securities. It is therefore important that American Railroad securities should be considered among the best.

"The Economist," one of the leading financial journals of

England, assumes that there were at the end of August 20,400,000 men actually under arms, including the mobilized troops of the neutral European States. It estimates ten shillings per day as the cost of a soldier's keep. This would mean an expenditure for this purpose alone of over \$50,000,000 per day. This does not take into account other enormous, wasteful expenditures, directly for military purposes and otherwise. Then, of course, there remain the large demands for capital for the peaceful purposes of industry. Military expenditures will continue for some time after the cessation of hostilities, as demoralization cannot take place at once and must necessarily be gradual. Then, too, there will spring up additional demands for money to repair the waste of war. We may therefore, for years to come, look for a tremendous demand for capital.

As to the supply—with so many men killed, temporarily invalided, or permanently disabled, and with so many of the facilities of production crippled and destroyed—it will take time for production to get back to where it was before the war.

Loans to an unprecedented amount will therefore be required by foreign governments and foreign corporations. The great demand for capital and the diminished supply will have an important effect on interest rates the world over. All the more reason, then, that American railroad credit should be placed upon so high a level as to enable the roads to secure money on the most favorable terms.

Now, whether or not justified, there has been a growing feeling in this country, and even more so in Europe, that American railroad securities are no longer as safe investments as they were formerly. This feeling has not been principally due to mismanagement in individual cases—although those cases have undoubtedly helped. The principal reason is the belief of investors that, while permitted to take the chance of loss, they are not to be permitted to make profits, and, in some cases, are not to be permitted even to obtain prevailing rates of interest on their investment. If return on capital invested in railroads is not to be permitted to exceed or even to equal current rates of interest, then “investors will seek other fields where the hazard is less or the opportunity greater.” (Report of Railroad Securities Commission).

“Neither the rate of return actually received on the par value of American railroad bonds and stocks today, nor the security which can be offered for additional railroad

investments in the future, will make it easy to raise the needed amount of capital.

“Nor can the security which most of our railroads offer be regarded as exceptional. The underlying bonds of the older systems are doubtless secure. It is not probable that even a grave commercial crisis will affect the return of a trunk line first mortgage. But very little of the new capital can be raised on securities of this kind. *Most of it must come either from bonds which will not be a first lien for many years, or from new issues of capital stock.* The investors in these securities, and especially in stocks, take risks which cannot be accurately forecast. Apart from probable fluctuations in traffic and possible increases in cost of operation, new inventions may at any time render much of their present plant antiquated.”

(Report of Railroad Securities Commission.)

The effect of diminishing net earnings and, worse yet, of a diminishing surplus for pro-rate over an increasing amount of stock and of low prices due to these and other causes, is very depressing on the investor's mind, and the effect of this depression has already been felt in the investment market for railroad securities. What is required is the restoration of confidence in the investor, especially in the *European* investor, as in the present crisis *he* is a factor of tremendous importance, for on *him* depends, as I shall now explain, how much additional gold is to be exported by this country.

Whenever the stock exchanges open, a large amount of American railroad securities held *abroad* will certainly be offered for sale because the owners thereof will require money. If to these inevitable sales, additional sales are to be added because *foreign* holders of American railroad securities have lost confidence in their investment, we shall have the doubly unfortunate condition of *European* holders *selling* because of lack of confidence and the *American* investor, also because of lack of confidence, *loath to buy* except at extremely low prices. The bearing of this on the international exchange situation needs but to be mentioned in order to be appreciated. The bankers of this country have been trying ever since the breaking out of the war to re-establish international exchange upon a normal basis and are perhaps now in a fair way to succeed, provided no new disturbing element appears. If of the four or five thousand millions of American securities said to be held abroad (the greater part of which are railroad securities), only a moderate amount—say only ten or fifteen per cent.—should be sold here,

the result would be appalling, not only by reason of the consequences resulting from the decline in prices, as explained above, but more particularly because of the enormous increase in the export of gold that would necessarily follow. The national banks of the country hold approximately \$625,000,000 of gold. There is, of course, more gold than that in the country, not only in the State banks and trust companies and in the United States Treasury, where it is within control, but also in the pockets of the people where it is not within control. Our Federal Reserve Banking system is not yet in working order. The gold of the country has therefore not yet become concentrated where it ought to be, in bank vaults, but it still circulates very largely among the people, where it is of no economic use and where paper money would serve quite as well. The blockade in the usual movement of cotton to Europe, in addition to cutting down the earnings of the Southern railroads, is adversely affecting, by many hundred millions of dollars, our foreign trade balance and is thereby further aggravating the foreign exchange situation. The effect of this upon gold exports has not yet by any means been felt to the full extent. To minimize the further export of gold is the work in which the bankers of the country, working in co-operation with the Government, are now engaged. If their efforts should fail by reason of a deluge of foreign selling, it is quite conceivable that this country might have to suspend gold payments. One way to help avert this is to restore confidence in our securities.

England recognizes the importance of maintaining on a reasonable price level, the securities listed on the London Stock Exchange, and if I am correctly informed, is now considering the advisability of a government guarantee to English banks and bankers, in order to induce them to continue carrying existing loans on the present pledged security. Conservative England, which up to now has been more chary than any other country of extending government aid to private enterprises, finds herself not only considering this step, but actually guaranteeing earnings to the railroads, so I understand, during the time that the government is using them in part for military purposes. But England's problem is a comparatively easy one, for England is a creditor country, with moneys due it, for interest and dividends on capital invested in foreign countries, for freight earned by its shipping interests, for insurance premiums, and for services rendered by its acceptance houses and banks and generally for

financing by its enormous credit facilities, the industries of the world.

We are a debtor nation. It is we that owe to England for these services. Gold, therefore, naturally flows to England, when England is not making further investments abroad, and it is an interesting fact that the enormous expansion of bank loans in England, due largely to the Bank of England's having, under government guarantee, taken over the ante-bellum obligations of its bankers and financial institutions, has been made comparatively easy by a gold reserve higher than it has ever been in the history of that country. I do not say that the *percentage* of reserve is higher, for it is not (it is in fact considerably lower), but the actual *amount* of gold is greater.

We, on the contrary, have been losing *gold* steadily—since January 1, 1914, we have exported not less than \$140,000,000 and being a debtor nation we shall probably for a time continue to lose gold, even without being compelled to buy back our own securities. Now, if a debtor nation is required to buy back even a small part of its obligations to creditor nations, i. e., required to pay its debts to foreign countries, on the instant, through sales in large amounts by foreign holders of its securities, on its Stock Exchanges, the effect must necessarily be a tremendous export of gold. But, if Europe, and more particularly, England, can be made to see that our railroad securities are good, that the railroads are receiving the protection of the United States Government, both directly and through the Interstate Commerce Commission, if it can be made to realize that earnings and therefore dividends, are likely in good times to be increased rather than diminished, and in bad times to be conserved when possible, if it can be made to see that the equities in these properties are to be protected and their value enhanced, then at least we may be spared the calamities resulting from a lack of confidence on the part of the foreign investor, in the future of American railroad securities. As it is, we shall have to buy back a great many of foreign held American railroad securities, because their owners will be in need of money, and this will be a serious enough problem to handle, without the added complication of distrust in their value.

It may be thought by those who take a narrow view of the subject that it is not a part of the duty of the Interstate Commerce Commission to concern itself with the prices of stocks or bonds. Whatever may be true in ordinary times, and in my

judgment the Interstate Commerce Commission can never safely ignore this factor, under present conditions of stress and strain it is certainly the duty of the Interstate Commerce Commission to do everything in its power to prevent low prices of railroad, and indirectly therefore, of other securities. And I say "other securities" because the prices of other securities almost invariably take their tone from that of railroad securities. These furnish the standard of prices. If the prices of railroad securities are depressed, so will be those of other industries. The country cannot prosper unless the railroads prosper. This is axiomatic; but at the present time it is truer than ever before. It is needless to point out that corporations seeking to finance themselves cannot sell their securities at prices above the market. It is, therefore, distinctly to the interests of all the people of this country, shippers and travellers and others, that the Interstate Commerce Commission should do everything in its power to maintain a high level of prices for railroad securities.

It may seem to the Commission that this is a very much overdrawn picture and that an increase of 5 per cent. in rates to be charged by the roads in Official Classification Territory cannot be the sole factor in determining whether this country is to proceed with the orderly re-establishment of its damaged credit and business structure, or whether everything is to go to ruin. This is unquestionably so; but it is also true that the other remedial measures which may be necessary, are not within the power of the Interstate Commerce Commission to grant or withhold. Further remedial measures will in my judgment have to be undertaken, some by the banking interests of the country, some perhaps by the United States Government, and some by the State Governments and Public Service Commissions, but the only remedy that it is within the power of the Interstate Commerce Commission to provide, is a rate increase to the full extent asked for. Railroad securities have so far fallen into disrepute that even Receivers' certificates, until recently regarded as unassailable investments, have in some cases been renewed only by means of forced extensions.

The crisis is immediate and the remedy must be immediate also. It is of no use now to speak of economies of operation. These should be undertaken and must be undertaken in due course. Immediate relief in part, lies within the power of the Commission to grant, and this, in my judgment, it ought to grant in order to re-establish confidence in American railroad

securities and to check the further export of gold. If in better times and under other conditions the increased rates now asked for should be found to be too high, it is within the power of the Interstate Commerce Commission *then* to order a reduction as it is *now* within its power to grant the increase.